

OPEN MEETING AGENDA ITEM

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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS ANTHEM
WATER DISTRICT AND ITS SUN CITY
WATER DISTRICT.

Docket No. W-01303A-09-0343

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS
ANTHEM/AGUA FRIA WASTEWATER
DISTRICT, ITS SUN CITY WASTEWATER
DISTRICT AND ITS SUN CITY WEST
WASTEWATER DISTRICT.

Docket No. SW-01303A-09-0343

Arizona Corporation Commission

DOCKETED

DEC 9 2010

DOCKETED BY

[Signature]

EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

The Residential Utility Consumer Office ("RUCO") makes the following Exceptions
to the Recommended Opinion and Order ("ROO") on Arizona American Water Company's
("Arizona American" or "Company") application for a rate increase.

1 **SUMMARY**

2 The adoption of the ROO will result in excessive rates. First, the Anthem/Agua Fria
3 ratepayers will in all likelihood be paying twice for the water infrastructure that services their
4 territory. Second, the Commission will be sending a signal that post test year ratemaking
5 rather than historical test year ratemaking is preferable. Finally, the Company will enjoy a
6 return on equity ("ROE") which is more than 100 basis points greater than what is fair in this
7 case. The ROO proposes a 10.7% ROE while RUCO recommends a 9.5% ROE. For any one
8 of the above reasons, the result will be rates that are excessive and should not be approved by
9 this Commission.

10 **INTRODUCTION**

11 RUCO, through its rate analyst, Ralph Smith, presented numerous, well reasoned and
12 fair adjustments to the Company's rate base, operating income and operating expense
13 recommendations, each of which would provide the ratepayers with rate relief. Almost every
14 one of RUCO's recommendations was rejected. Instead, the ROO recommends approval of
15 Staff's recommended increases for every district to the dollar except Anthem/Agua Fria
16 Wastewater. For Anthem/Agua Fria Wastewater the ROO recommends a \$20,000 difference
17 from Staff's recommendation on over \$5 million of increased revenues (ROO - \$5,031,198.00,
18 Staff - \$5,051,198.00).

19 If the ROO is approved as is, for example, Anthem Water customers and Anthem/Agua
20 Fria Wastewater customers will be subject to increases in total revenues of 79.12% and
21 58.25%, respectively.. ROO at 62. When ascertaining just and reasonable rates, it is
22 incumbent upon the Commission to consider all of the facts and circumstances in any given
23
24

case. These increases and the proposed increases for the other divisions in this case are simply not reasonable, or fair, under the facts and circumstances of this case.

The ROO adopts Staff's and the Company's recommendation for a 10.7% return on equity. A 10.7% cost of equity is out of line with what the Commission has been awarding water companies recently. For example, in the LPSCO rate case decided on November 22, 2010, the Commission approved an 8.01% return on equity. Other recent examples of return on equity awards authorized by the Commission are:

<u>Company</u>	<u>Cost of Equity</u>	<u>Cost of Debt</u>	<u>Cap. Structure</u> <u>L-T Debt/S-T Debt/Equity</u>	<u>WACC</u>
Arizona Amer.	9.90%	5.46%	58.68/41.62	7.33% ¹
Arizona Water	9.50%	6.83%(LT) 4.8%(ST)	45.85/4.8/49.35	7.87% ²
Chaparral City	9.90%	5.0%	24.0/76	7.52% ³
Global Water (4 systems)	9.00%	varied	approx.40/60	7.60%- 8.08% ⁴
Sunrise Water	10.0%	n/a	100/0	10.0% ⁵
UNS Gas	9.50%	6.49%	50/50 approx.	8.00% ⁶

Awarding a high cost of equity to a utility in the current economic environment is counter-intuitive for many reasons. Most notably, regulated utilities have a guaranteed customer base and represent attractive investments to investors in markets experiencing a downturn. There are the other, technical reasons RUCO presented at hearing why a 10.7% return on equity is too high in this case. In addition, RUCO believes the Commission should

¹ In the Matter of Arizona American, Decision No. 71410 issued on December 8, 2009.

² In the Matter of Arizona Water Co., Decision No. 71845 issued on August 25, 2010.

³ In the Matter of Chaparral Water Co., Decision No. 71308 issued on October 21, 2010. Note: FVROR which includes inflation adjustment of 1.2% which reduced WACC to 7.52%.

⁴ In the Matter of Global Water Co., Decision no. 71878 issued September 15, 2010.

⁵ In the Matter of Sunrise Water Co., Decision No. 71445 issued on December 23, 2009. Note Sunrise Water is a very small company with an OCB of 1.1 million. Staff and the Company stipulated to a 10% ROE.

⁶ In the Matter of UNS Gas Co., Decision No. 71623 issued on April 14, 2010.

1 factor all information into the Commission's deliberations in this case to add further support for
2 RUCO's recommended and generous 9.5% return on equity.

3 The ROO explains in great detail the arguments raised by the Anthem Community
4 Council ("Council") in support of its recommendations to exclude the "Pulte Balloon
5 Repayments" in rate base. The ROO ultimately concludes that there was no evidence raised
6 in the record that showed the refund payments to be unreasonable or improper⁷. ROO at 37.
7 However, after the hearing and even after parties filed their Closing Briefs, significant and
8 relevant information came to light. On October 6, 2010, Bob Golembe, an Anthem ratepayer,
9 filed the unpublished order of the Honorable Frederick J. Martone in what was then pending
10 litigation in the United States District Court entitled *Grimmelman v. Pulte Home Corporation*,
11 *No. CV-08-1878-PHX-FJM*. *Grimmelman* was being litigated as the rate case was proceeding,
12 and at hearing, Commissioner Pierce raised questions and sought answers regarding this
13 outside litigation. See Phase I Transcript 388:18-392:18. In the unpublished order filed in the
14 docket by Mr. Golembe, there is a reference to the Anthem subdivision report application filed
15 by Pulte with the Arizona Department of Real Estate where Pulte indicated that the costs of the
16 infrastructure to the purchaser's lot line as well as the infrastructure to the purchaser's dwelling
17 is included in the purchase price of the house. RUCO and the Council made a joint filing of the
18 subdivision report application on November 9, 2010.

19 RUCO has participated in previous Anthem Water rate cases and has been steadfast in
20 its position that, legal challenges aside, it would not be fair to the Company not to allow the
21 Company to recover its refund payments. The infrastructure in question is used and useful,

22
23 ⁷ The Commission in the prior Anthem rate case (Decision 73072 at 43) left the issue open for further analysis
24 should any party want to raise it in a subsequent rate case.

1 and everyone that was involved at the inception knew what the deal was - Anthem ratepayers
2 to repay the infrastructure costs without interest – or at least thought they knew what the deal
3 was. RUCO has always been under the impression that the ratepayers would only pay once
4 for the costs of the infrastructure. With the revelation of the subdivision report application, it
5 now appears that the ratepayers will be paying twice – once through the purchase price of their
6 house and again in their utility rates. If, in fact, Pulte has recovered the costs of the
7 infrastructure in the purchase price of the homes, it is unreasonable and unfair for ratepayers
8 to have to pay for the infrastructure a second time in their utility rates. RUCO will not comment
9 on whether the Company has recourse against Pulte, but surely the ratepayers should not
10 have to pay for the infrastructure costs through their rates if they already paid the costs in the
11 purchase price of their house.

12 In Decision No. 70372 the Commission stated *"Our determination in this case is not*
13 *intended to have any bearing on our determination in any subsequent case....regarding the*
14 *reasonableness of the ("Pulte Repayments")."* (at 43.) RUCO believes that the Commission
15 can consider the Dept. of Real Estate filing when establishing fair and reasonable rates. The
16 ROO recommends large revenue increases and one area where the Commission can exercise
17 its discretion is the cost of capital it awards. For this reason and others which will be
18 addressed below, a 9.5% return on equity in this case is generous, fair and reasonable and is
19 the maximum amount that should be awarded in this case.

20 **The Commission should remove post test year plant and expenses in order to mitigate**
21 **rate shock.**

22 As mentioned above, RUCO made numerous rate base and operating income and
23 expense adjustments which would have the effect of ameliorating the rate increase. The ROO
24 rejects most of RUCO's recommendation for various reasons. However, the ROO has

1 approved an unusual number of post test year based calculations on what appears to be a
2 concern that the Company will underearn if RUCO's recommendations were to be approved.
3 For example, see ROO at 48. This post test year ratemaking explains, in part, why the
4 proposed rates in this case are excessive.

5 The Commission is charged with balancing the ratepayers and the shareholder's
6 interests. Nobody, including the ratepayers, wants to see a utility struggling financially. If a
7 utility does underearn and does so continuously, its financial integrity will undoubtedly be
8 compromised. The Commission's concern that a Company will underearn is a valid concern.

9 However, the concern must be placed in a proper context. The benefit of regulation for
10 the Company is that if it becomes troubled financially, its recourse is not bankruptcy court - the
11 recourse of its non regulated counterparts. The utility can file a rate case and seek to increase
12 its revenues. This also explains why regulated utilities are an attractive investment to
13 investors, especially during economic downturns (which will be explained in more detail
14 below).

15 On the other hand, if the Commission sets the Company's revenue requirement based
16 on calculations that are estimates or have no historical basis, there is a real concern that the
17 Company will overearn. Unlike the shareholder in the underearning situation, the ratepayer
18 has no recourse where the Company overeans. The Company will continue to overearn and
19 will not come in for a rate case unless the Commission orders it to or until it starts to underearn
20 – another benefit to the shareholder at the expense of the ratepayer.

21 This disparity explains why it is critical from RUCO's perspective that the Commission
22 stays the course in utilizing the historical test year principle. RUCO understands that there are
23 some instances where the use of post test year adjustments is appropriate. Here, however,
24 there is a clear preference for post test year ratemaking which has resulted in excessive rates.

1 In the interest of brevity, RUCO will list most of the ratebase and operating adjustments
2 that were rejected, and provide a short explanation of the issue and RUCO's position including
3 the numbers at issue.

4 **Post Test Year Plant**

5 The test year ended December 31, 2008. RUCO recommends the exclusion of a Well
6 that went into service in May 2009 in the Sun City Water District. RUCO recommends
7 exclusion of **\$1,587,149 of post test year plant.**

8 **Pension Expense**

9 There are two parts to the pension expense issue. The first part concerns the
10 appropriateness of using ERISA versus FAS 87 to account for pension expense. The second
11 issue concerns the appropriate pension expense amount. The ROO recommends using the
12 ERISA accounting methodology and allowing the Company to recover **\$2.090 million** based
13 on funding payments into its defined pension plan trust for **post-test-year 2009**. RUCO
14 recommends the use of the TY 2008 FAS 87 amount of \$958,949. The 2008 actual FAS 87
15 amount is lower than the test year ERISA amount (\$1,734,561) but is not totally out of line with
16 the amounts of FAS 87 pension expense for prior years.

17 **Other Post Employment Benefit Expenses ("OPEB")**

18 The ROO recommends using **post test year 2009** OPEB expense. RUCO's adjustment
19 normalizes the OPEB expense using an average of 2007-2008 as the basis for deriving a
20 normal level of ratemaking. RUCO's adjustment would decrease OPEB expense for all of the
21 districts in the amount of \$10,389.
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1 **Annual Incentive Plan ("AIP") for the Company's affiliate**

2 The ROO recommends the disallowance of 30% of the affiliate's AIP expense. RUCO's
3 expert, Ralph Smith, recommends 100% disallowance. RUCO believes that it is inappropriate
4 to charge AAWC's ratepayers for affiliate incentive compensation that is premised on a parent
5 company's financial trigger whose operating income and corporate financial results are
6 influenced by operating income of non-jurisdictional and non-regulated operations of American
7 Water Works. RUCO's adjustment would reduce operating expenses by \$256,853.

8 **Post Test Year Pay Raise for affiliates**

9 The ROO recommends a 4% **post test year** (March 2009) pay increase for its affiliate
10 company's employees. RUCO did not oppose the test year wage increase but opposes the
11 post test year wage increase. RUCO's adjustment reduces the Company's requested
12 operating expenses for the six districts by \$89,678.

13 **Rate Case Expense**

14 The ROO approves the Company's requested \$678,475 of rate case expense. RUCO
15 recommends recovery of \$460,000 in rate case expense amortized over three years based on
16 the amount awarded in the Company's last rate case (Decision No. 71410) - \$456,275, which
17 involved seven districts. This case involves five districts.

18 **The Commission should reduce the cost of equity from 10.7% to 9.5%.**

19 The ROO's recommendation appears to be based on the level of risk in the Company's
20 capital structure. ROO at 61. Its capital structure includes 61% debt / 39% equity. In terms of
21 risk, the Company cannot be viewed in a vacuum. As the ROO acknowledges, the Company
22 is a wholly owned subsidiary of American Water Works, the largest investor owned water and
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1 wastewater utility in the United States. ROO at 8. This connection affects a utility's risk in a
2 cost of capital analysis. In the pending Rio Rico rate application (Docket No. WS-02676A-09-
3 0257 at 34) the ROO notes:

4 The Company's claim that RRUI is riskier than the larger entities used
5 in the proxy sample fails to consider that RRUI is part of the much
6 larger APIF family of companies. The Company did not offer objective
7 evidence that RRUI is entitled to an upward adjustment of its authorized
8 rate of return in order to attract capital at reasonable rates.

9 Rio Rico ROO at 34.

10 In the subject case, the Company's parent has been issuing debt at historically low
11 rates. In its most recent 10-K filing, the Company's parent issued commercial paper at 0.39%
12 as of December, 2009.⁸ The average rate on the Company's commercial paper issuances has
13 also lowered significantly resulting in a lower cost of short term debt which should result in a
14 lower weighted average cost of capital. This point was raised during the first phase of the
15 evidentiary hearing when Anthem's witness, Dan Neidlinger responded to questions regarding
16 the drop in the Company's commercial paper rate to an average of 0.75%.

17 RUCO's 6.77% weighted average cost of capital is based on a cost of short-term debt of
18 3.41%. Had RUCO incorporated the more current 0.39% rate, RUCO's recommended
19 weighted average cost of capital would have fallen 40 basis points, from 6.77% to 6.37%.

20 Finally, the Federal Reserve has also taken actions which support a lower weighted
21 average cost of capital. In March of this year, the Federal Reserve decided not to increase or
22 decrease the federal funds rate and kept it between zero and 0.25%. In doing so, the Federal
23 Reserve confirmed its plan to keep interest rates "exceptionally low" for a long time.⁹ More

24 ⁸ *Id.* See also Exhibit R-5, 2009 Annual Report of American Water Works.

⁹ Minutes of the Federal Open Market Committee meeting held on March 16, 2010
<http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20100316.pdf>.

1 recently, the Federal Reserve announced plans to purchase \$600 billion in U.S. Government
2 bonds over the next eight months to drive down long-term interest rates.

3 In sum, the ROO's cost of capital recommendation is too high. It is inconsistent with the
4 Company's current financial condition and out of line with the current state of the economy. It
5 should also be lowered for equity reasons.

6 **RUCO's withdrawal of its alternate phase-in proposal.**

7
8 RUCO withdrew the proposal after numerous meetings with interested parties because
9 it became clear to RUCO that due to carrying costs no version of RUCO's proposal would
10 actually result in a rate design more beneficial to ratepayers than RUCO's stand-alone rate
11 design.

12 In the recent Global rate case, a phase-in proposal was suggested to help ameliorate
13 the impact of the rate increase. Global agreed to waive these additional costs in order to help
14 the ratepayers in that case. Even in the recent Pennsylvania-American rate case, the
15 Company agreed to phase in rates without assessing carrying charges. (R-2010-2166212).
16 Should the Company in this case consider such a course of action, RUCO would happily offer
17 its alternate phase-in proposal for the Commission's consideration.

18 **Finding of Fact 197 is not correct.**

19 RUCO believes that there is an error in Finding of Fact 197. New rates for the average
20 Anthem/Agua Fria wastewater residential user are calculated using an average consumption of
21 5,632 gallons. This is incorrect.

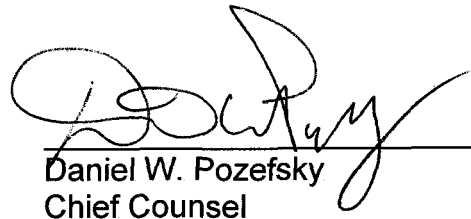
22 5,632 gallons is not the correct average to be used in calculating the impact to the
23 average residential ratepayer because of the change in the rate design adopted by the ROO.
24 Under current rates, the Anthem/Agua Fria wastewater residential ratepayers are charged only

1 up to the first 7,000 gallons of water consumed during that month. The 7,000 gallon cap is
2 what brings the average wastewater consumption down to 5,632 (compare the actual average
3 $5/8 \times 3/4$ water consumption of 6,919 gallons per month for Anthem).

4 The ROO's new rate design will (1) take off the 7,000 gallon cap and (2) charge a per
5 1,000 gallon rate for wastewater based on averaging the actual water consumption of
6 residential ratepayers in January, February and March. The average consumption for Agua
7 Fria ratepayers in January-March of the test year was approximately 7,800 gallons. The
8 average consumption for Anthem ratepayers in that same time period was 8,100 gallons.

9 Accordingly, the 14% increase in rates in Finding of Fact 197 is not correct. It is actually
10 much, much higher.
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1 RESPECTFULLY SUBMITTED this 9th day of December, 2010.

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4 
5 Daniel W. Pozefsky
Chief Counsel

6 AN ORIGINAL AND THIRTEEN COPIES
7 of the foregoing filed this 9th day
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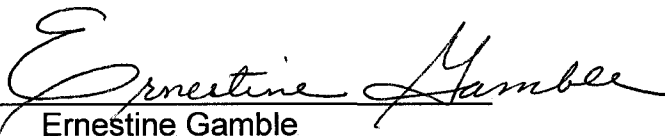
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17
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Arizona-American Water Company
W-01303A-09-0343

Attachment A

RUCO's Amendment No. 1

(Cost of Capital)

This proposed amendment reduces the cost of equity from 10.7% to 9.5%.

DELETE Page 60 Lines 14 starting with "while RUCO argues ..." – line 18.

INSERT It is counter-intuitive to assign a higher cost of equity to a utility in the current economic environment. As RUCO points out, in markets experiencing a downturn, regulated utilities are an attractive investment to investors. Regulated utilities are monopolies with a guaranteed customer base. Hence, the risk associated with regulated utilities is generally lower than their non-regulated counterparts. The lower risk is attractive to investors in a bad economic climate. Investors understand that the lower risk comes at a price--lower returns.

DELETE Page 61 Lines 8 – 19

INSERT We find that of the proposed cost of equity estimates, RUCO's is the most reasonable because it properly accounts for the level of risk in the Company's capital structure. The lower risk of regulated utilities is attractive to investors in a bad economic climate. The Company is a wholly owned subsidiary of American Water Works, the largest investor owned water and waste-water utility in the United States. The Company's parent continues to rely on low cost debt financing to fund its capital improvements. In terms of risk, the Company cannot be viewed in a vacuum. The average rate on the Company's commercial paper issuances has also lowered significantly resulting in a lower cost of short-term debt which should result in a lower weighted average cost of capital.

RUCO's 6.77 percent weighted average cost of capital is reasonable. It is based on a cost of short-term debt of 3.41 percent, a cost of long-term debt of 5.47 percent, and a cost of common equity of 9.50 percent. RUCO could have also adjusted its cost of capital recommendation downward if it factored in to its final weighted average cost of capital analysis the more recent rate at which the Company actually issues commercial paper (.39 percent), but it did not.

MAKE ALL CONFORMING CHANGES

RUCO's Amendment No. 2

(Rate Base and Operating Income)

This proposed amendment makes several adjustments which may be adopted individually or in its entirety.

Post Test Year Plant

Delete Page 12 lines 11 – 14.

Insert The Company made a similar request to include post test year plant in its Company's last rate case. In Decision No. 71410 we denied the Company's request to include \$2,046,765 of post-test-year plant in the Company's Aqua Fria Water District. We noted that the Company had not demonstrated any special or unusual circumstances. The Company has not demonstrated special or unusual circumstances to justify the inclusion of the \$1.587 million for the new well in Sun City. Therefore, we deny the Company's request to include \$1.587 million for the new well in Sun City.

MAKE ALL CONFORMING CHANGES

Pension Expense

Delete Page 47 lines 17 – Page 48 line 17.

Insert By virtually any historical measure, the Company is seeking to recover an exceptionally high amount of pension expense. Largely as a result of the poor financial market performance in late 2008 during the worldwide financial crisis, the cost related to the Company's defined benefit pension plan has increased. There are two parts to the pension expense issue. The first part concerns the appropriateness of using ERISA versus FAS 87 to determine the ratemaking allowance for pension expense. The second issue concerns the appropriate pension expense amount.

The Company's request is based on a cash funding approach, referred to as ERISA. The cash funding approach provides for an extremely wide amount of discretion of management on how to fund the plan each year. Arizona American employees participate in pension plans of American Water Works. For American Water Works, the parent company, the annual range of cash funding of possible defined benefit pensions for the last couple of years was over \$600 million. Management's discretion as to the amount of cash funding is so broad that it could hardly be called being held to a standard. Even basing the ratemaking allowance at the ERISA minimum funding amount, as the Company has requested, would subject ratepayers to unreasonable and abnormally high amounts of defined benefit pension expense. The Company is requesting to recover \$2.090 million, before allocation among districts, based on funding payments into its defined pension plan trust for

post-test-year 2009 based on ERISA minimum funding. This is a \$355,439 increase over the test year recorded amount of \$1.735 million, or 20.5%. The test year amount of "ERISA" pension cost itself was substantially higher than in any prior year as summarized in the following table:

Year	Actual ERISA		FAS 87	
	Recorded		Expense	
2004	\$	146,893	\$	801,536
2005	\$	317,798	\$	829,028
2006	\$	1,013,141	\$	895,281
2007	\$	903,222	\$	880,693
2008	\$	1,734,561	\$	958,949

We find the FAS 87 approach to be preferable over the Company's ERISA proposal. FAS 87 has been widely accepted in the regulatory field, and is the approach used for ratemaking recognition of pensions for the other major utilities in the state, including APS. Unlike the ERISA approach, the FAS 87 accounting provides for pension cost amounts that are consistent with generally-accepted accounting principles. The FAS 87 accounting amounts are used for financial reporting purposes. If they are out of line with historical experience, as the pension costs for American Water Works and its affiliates are, they can be adjusted or normalized accordingly by using an average.

Concerning the amount of pension expense allowance, RUCO's recommendation to use the TY 2008 FAS 87 amount of \$958,949 is fair and reasonable under the circumstances of this case. The 2008 actual FAS 87 amount is lower than the test year ERISA amount (\$1,734,561) but is comparable with the amounts of FAS 87 pension expense for prior years, as shown in the above table.

Based on a thorough evaluation of all of the evidence presented in this proceeding we adopt RUCO's recommendation to use the actual TY 2008 FAS 87 amount of \$958,949 as the defined benefit pension plan allowance before allocation to districts.

MAKE ALL CONFORMING CHANGES

Other Post Employment Benefit Expenses ("OPEB")

Delete Page 49 lines 10 – 20.

Insert We agree with RUCO that the appropriate ratemaking treatment is to normalize the OPEB expense using an average of 2007-2008 as the basis for deriving a normal level of ratemaking. The post test year 2009 OPEB amounts are significantly higher than the last five years, 2004-2008 and therefore it is appropriate to normalize the OPEB expense using the test year amount.

MAKE ALL CONFORMING CHANGES

Annual Incentive Plan ("AIP") for the Company's affiliate

Delete Page 51 lines 6 starting with "The evidence..." – Line 12.

Insert We agree with RUCO that it is inappropriate to charge AAWC's ratepayers for affiliate incentive compensation that is premised on a parent company's financial trigger whose operating income and corporate financial results are influenced by operating income of non-jurisdictional and non-regulated operations of American Water Works. Per the terms of the API, the diluted earnings per share target for the entire American Water Works Corporation (the parent, AWWC) has to be achieved before incentive compensation is awarded based on the Plan. The parent company, American Water Works, corporate financial income is only moderately influenced by AAWC's operating results and is heavily influenced by non-Arizona jurisdictional operations as well as American Water Works' non-regulated operations. Facts in the current case that were not presented to the Commission in prior Arizona American rate cases also demonstrated that base salaries of Arizona American as well as the affiliated service company, AWWSC, which participates in the AIP, are targeted to the 50th percentile of market compensation, whereas the AIP is targeted at the 65th percentile. Anything above the 50th percentile could be considered to be above market and hence unreasonable to charge to ratepayers, especially in the current difficult economic times. The AIP provides an opportunity to earn even higher amounts, once its overall American Water financial trigger, which is based on American Water Works' corporate diluted earnings per share, is reached. This information was not presented in the last AAWC rate case when we approved a 30% AIP disallowance of AIP expense from the Management Fees charged to AAWC from the affiliated service company. Given the facts presented in the current case and the difficult economic climate, , we adopt RUCO's adjustment to remove 100% of the AIP for the affiliated service company changes that are contained in the Management Fee charged by AWWSC to AAWC. Making reasonable adjustments such as this one will also help mitigate the high rate increases resulting for districts.

MAKE ALL CONFORMING CHANGES

Post Test Year Pay Raise for affiliates

Delete Page 51 lines 21 starting with "We find that..." – Page 52 line 1.

Insert We will not approve the Company's requested 4 percent post test year (March 2009) pay increase for its affiliate company's employees. We recognize that given the present economic environment every dollar counts and now is not the time to be placing the responsibility of post-test year wage increases on the unemployed and other ratepayers who are being forced to cut back to survive the economic downturn.

MAKE ALL CONFORMING CHANGES

Rate Case Expense

DELETE Page 53 lines 13 – 16

Insert We adopt RUCO's recommendation. This case involves five districts. In the Company's last rate application there were seven districts involved. In that case (Decision No. 71410) we approved rate case expense totaling \$456,275, normalized over three years. In other recent Arizona-American cases, we awarded \$300,000 in rate case expense where there was only three-districts (Decision No. 70372) and \$94,264 in a one-district case (Decision No. 70351). By comparison, RUCO's recommended rate case expense allowance of \$460,000 in total normalized over a three-year period for an annual allowance of \$153,333 is fair and reasonable and we shall therefore adopt it.

MAKE ALL CONFORMING CHANGES

RUCO's Amendment No. 3

(Finding of Fact 197)

This proposed amendment recalculates the impact of the rate increase for the average Anthem/Agua Fria Wastewater ratepayer.

DELETE Page 112 FOF 197

~~Under the rates adopted herein, an average water usage (5,632 gallons per month) anthem/Agua Fria Wastewater district residential customer with a 5/8 x 3/4-inch water meter will experience an increase of \$6.69, approximately 14.13 percent from \$47.36 per month to \$54.05 per month.~~

INSERT Revised FOF 197 "Since the new rate design eliminates the 7,000 gallon per month cap when calculating the wastewater charges, under the new rate design and the rates adopted herein, an average water usage (8,140 gallons per month in Anthem and 7,580 gallons per month in Agua Fria) residential customers with a 5/8 x 3/4-inch water meter will experience an increase of \$30.76 (Anthem) and \$25.38 (Agua Fria) per month from \$47.36, approximately a 64.95% increase (Anthem) and 53.59% increase (Agua Fria)."

MAKE ALL CONFORMING CHANGES